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SALOMON SMITH BARNEY

EQUITY

RESEARCH

UNITED STATES

Online Media / Entertainment

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AOL and Time Warner Link

The Dynamic Duo Form a Free Cash Flow Dynamo

- **We believe the Internet and the evolving Media industry are enjoying a sustainable period of strong and predictable growth. At the intersection of these two worlds, we see an increasingly powerful sweet spot — the area of Internet/Media convergence.**

- **The proposed AOL/Time Warner merger would place the company at the center of these market forces, helping to define and shape development of converging Media and Internet industries in the next decade.**

- **We believe AOL Time Warner's leadership advantages in these dynamic markets will equate to rapid revenue growth, attractive profit margins, powerful free cash flow, and the potential to create significant shareholder value.**

- **In our view, a valuation of AOL Time Warner should not only reflect EBITDA growth and peer company valuations, but should also recognize the combined company's strong free cash flow and high free cash flow growth potential.**

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America OnLine# (AOL–$66.87)

Rating: 1H *(Buy, High Risk)*

FY June	1999A	2000E	2001E
Revenues (mil.)	$4,777.0	$6,650.0	$8,600.0
Current EPS	$0.17	$0.35	$0.50
Previous EPS		NC	NC
P/E	NM	NM	NM
TEV/EBITDA	NA	NA	NA
Price Performance	**1998**	**1999**	**YTD**
Absolute	NM	95.6%	-11.9%
Relative	NM	76.1%	-11.1%

	S&P 500: 1457
52-Week Range	$94-$41
Dividend/Yield	Nil
Shares Out (mil.)	2,460.0
Float (mil.)	NA
Est. 5-Year EPS Growth	60%
L-T Debt/Capital	8.1%
ROE (1999E)	0
Current Book Value	NA
Price/Book	NA

Time Warner# (TWX–$93.81)

Rating: 1H *(Buy, High Risk)*

FY December	1999A	2000E	2001E
Revenues (mil.)	$27,333.0	$29,623.0	$31,956.0
Current EPS	$0.40	$0.50	$0.91
Previous EPS		NC	NC
P/E	NM	NM	NM
TEV/EBITDA	NA	NA	NA
Price Performance	**1998**	**1999**	**YTD**
Absolute	100.2%	16.5%	29.7%
Relative	73.5%	-3.0%	30.6%

	S&P 500: 1457
52-Week Range	$94-$59
Dividend/Yield	$0.18/0.2%
Shares Out (mil.)	1,200.0
Float (mil.)	NA
Est. 5-Year EPS Growth	12%
L-T Debt/Capital	78.6%
ROE (1999E)	0
Current Book Value	$5.78
Price/Book	16.2x

Salomon Smith Barney is an advisor to America Online in its pending merger with Time Warner.

Executive Summary

The proposed formation of AOL Time Warner is a logical outgrowth of the way that the Internet and Media/Communications industries have begun to converge, by our analysis. The technical platform of the Internet has moved squarely into the center of the media world, and America Online is by far the No. 1 company on that stage. Likewise, the media industry has started to adopt new formats and distribution channels that are spurring faster growth, and Time Warner stands uniquely positioned to capitalize on those changes. Together, AOL Time Warner are expected to sit atop the wave.

Content is becoming more important and valuable online.
As more consumers use a growing array of access platforms to spend more time online, an increasing importance is placed upon high-quality, differentiated content. America Online (AOL) is already the leader in interactive and online software content, and Time Warner brings a very strong array of established and popular content brands that should allow AOL Time Warner to capture wider online viewership, more of each person's online media consumption, and an increasing share of the opportunity and value created by online media.

Interactivity and the Internet are becoming essential to media.
The established pillars of the Media industry — television, print, radio, movies, and music — are adapting to make room for and incorporate interactivity and the Internet as a permanent part of the industry's structure. Every inch of Time Warner, like the rest of the media landscape, is being affected by the Internet's growth. We believe, however, that in combining with AOL, Time Warner dramatically enhances its strategic position and breadth of business opportunity as the Media industry enters its newest cycle of reinvigorated growth.

AOL Time Warner bridges two powerful sources of growth.
We believe a combined AOL Time Warner will have all the ingredients — people, content, technology, infrastructure, brands, audiences, distribution platforms, financial wherewithal — to produce new forms of content and new interactive services that can define and model what the future of media will look like.

We value the combined company at $115 per share.
Although traditional EBITDA valuations will be used in analyzing the investment merits of a combined AOL Time Warner, we believe it will be the company's high quality and rapidly growing free cash flow that would set AOL Time Warner apart from any peers. We believe AOL Time Warner will be the most attractive place to invest in free cash flow growth among the stock market's existing leadership. We are maintaining our 1H (Buy, High Risk) rating on AOL and our 1H (Buy,, High Risk) rating on Time Warner.

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10. How long can AOL maintain its subscription price?

Pretty long, in our opinion. And, a lot longer than is currently being discounted by the market.

Admittedly, the logic against the longevity of AOL's premium subscription price seems pretty convincing: Why would anyone pay for Internet access when so many companies are starting to give access away? As consumers become more Internet-savvy and technology-literate, why won't they move beyond AOL, perhaps choosing a cheaper ISP and a MyYahoo! home page instead?

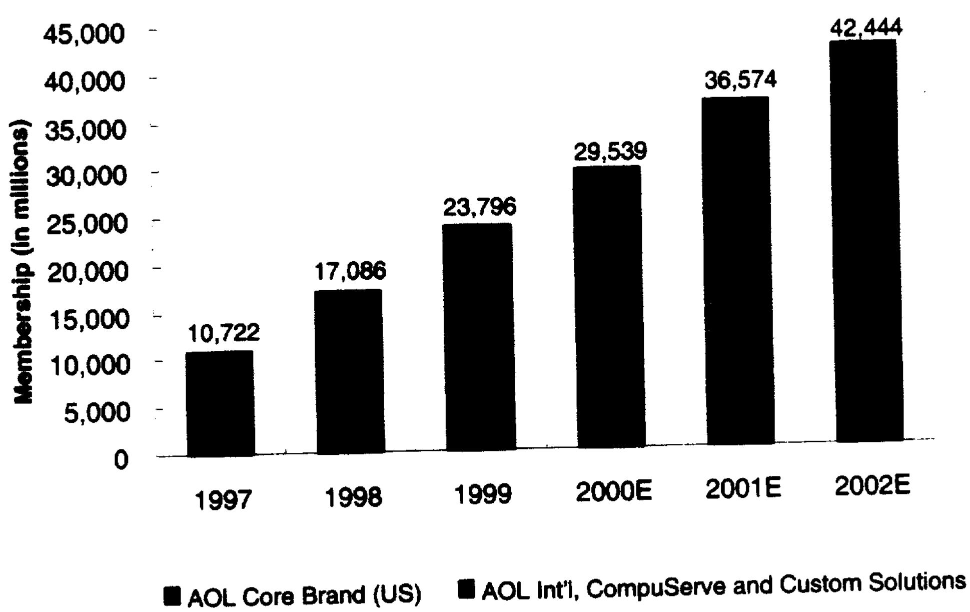
On ISP pricing, 1999 was a stiff test and AOL passed with flying colors.

Against that logic, though, one must look at the numbers: First, in the year following the launch of free Internet access provider NetZero (the company we would credit with leading the free access charge), AOL added 26% more net new subscribers to its core domestic service than it did in the year prior to the launch of its free competitors: 4.2 million vs. 3.3 million. Second, between NetZero's launch and the present, AOL's monthly average service revenue per member has climbed 5%, from $19.11 in September 1998 to $19.98 in December 1999. And, NetZero was by no means the only ISP trying to compete against AOL's pricing during that time. Third, between September 1998 and December 1999, AOL's operating margins more than doubled from 8% to 19.7%.

Clearly, cheaper and free ISPs have not yet hurt AOL's ability to maintain the $21.95 per-month price point, nor have they halted AOL's subscriber growth, nor have they eroded the company's profitability. The "Marlboro Friday meets AOL's pricing" anxiety is understandable in theory, but for those who have watched AOL manage into and through an ever more competitive ISP environment with its growth, pricing and profits intact, this is becoming a fairly worn-out worry.

Furthermore, AOL is one of the few Internet companies that has actually achieved legitimate success in the online industry's hallowed pursuit of "multiple revenue streams." While NetZero is chasing advertising/sponsorship revenue, and Earthlink is focused on subscription revenue, AOL outperforms both in each of these categories, and AOL leads as well in the e-commerce field. With CompuServe positioned as AOL's value segment flanker brand, and with Netscape or ICQ potentially sitting in the wings as "free" ISP brands, we believe that AOL is better equipped to compete across the full access marketplace than virtually any other player in the business.

Figure 1. America Online Membership



Source: Company documents and Salomon Smith Barney

A powerhouse brand and unique product command a premium price.

We believe that the bearish logic against AOL's long-term pricing power breaks down when it comes in contact with the mathematically unquantifiable power of the AOL brand. The AOL brand promise centers on making the Internet and online experience easy and convenient, and we would argue that AOL has gotten consistently better in those important two areas over time. The full AOL bundle of easy-to-use Internet access; readily-available e-mail, chat, instant messaging, and other services; simple and clean organization; and deep and rich content is still more unique in the marketplace than most other ISPs will admit. AOL has so solidly established and lives up to this brand image, an image so in sync with consumer needs and preferences, that simple economic logic seems to be irrelevant when it comes to AOL's premium pricing power.

Furthermore, from the consumer perspective, we believe AOL's "So easy to use, it's no wonder it's #1" marketing tag line is extraordinarily powerful. At once, the line delivers the AOL promise of ease of use, while simultaneously not only establishing AOL's leadership, but also creating a sense of "safety in numbers" for the new user or an existing user (i.e., "If there are 20 million other people like me using it, it can't be all bad."). What makes a brand is exceptionally hard to explain, and the financial impact of a strong brand is even more difficult to model. However, when a business such as AOL's outgrows, outprices, and out-returns as many seemingly equivalent, well-organized, and well-capitalized competitors, as does AOL, we believe the unexplained advantage must reside in the brand. As long as the AOL brand remains as strong as it is, we are hesitant to second-guess the ability of AOL to maintain its premium pricing.

Of course, there are other defenses for AOL's premium price point beyond just brand preference. First, AOL offers access from nearly anywhere, not only in the United States but overseas as well, and the quality of service on AOL tends at present to be fairly high. Phone company ISPs typically are not equipped for the roaming user in the same way as AOL, and cut-rate offerings often provide busy signals and more frequent disconnects.

Second, the content and services offered on AOL are of increasingly high quality. Features such as "You've Got Pictures" and MovieFone's planned print-your-tickets-at-home feature are presented in an easy and familiar format, and users get the sense of having new services placed conveniently at their fingertips. News, weather, and information from all kinds of leading sources are embedded throughout the AOL service.

With Time Warner, it may get easier to charge more.

Third, looking ahead, we believe that a combined AOL Time Warner would increasingly emphasize that AOL membership "has its benefits." We anticipate AOL Time Warner providing exclusive offers to its membership base, such as special magazine events (*à la* the *Sports Illustrated* Swimsuit Issue Exclusive Preview on AOL), early access to Time Warner music and entertainment products (e.g., the Madonna "American Pie" song release and *The Matrix* DVD, both of which were sold via AOL before hitting stores), and other exclusive "insider" benefits.

Fourth, as AOL begins to introduce wireless applications, AOL TV, the broadband AOL Plus service, and other expanded services, the company is likely to have opportunities to extract additional subscription revenue from existing accounts with minimum incremental marketing expenses, in our opinion. The growth of households with multiple AOL accounts for simultaneous users opens another avenue to defend — or perhaps increase — the subscription revenue. We believe all of these factors, and more, act to reinforce the premium value associated with subscribing to AOL relative to using a slimmed-down, bare-bones, content-less ISP alternative.

In sum, our view is that AOL's $21.95 per-month access price will last far longer than most observers expect to be the case.

9. How fast can the new company grow long term?

At least 25% per year on the EBITDA line, according to our analysis.

We expect rapid growth at the intersection of Internet and Media, AOL Time Warner's domain.

The pending merger of AOL and Time Warner, in our view, would bring together the two leading companies in two of the true growth segments of the world's economy: Internet and Media. The growth rate of the Internet marketplace is well established and continues to be fueled by an increasing returns dynamic that is spreading worldwide. As more and more consumers and businesses become hooked up to the Internet, the interactive and commercial connections between those people and organizations are steadily multiplying. The possibilities available on the Internet whether its places to shop, content to consume, people to interact with, software applications to use, businesses to trade with, or whatever are continually expanding, and the quality and richness of the online experience continues to grow. As a result, the impetus or incentive for new consumers and businesses to get online is continually expanding, drawing more participants into the network and sharing greater opportunity and value all around. By most measures, we believe AOL is the most successful company — certainly so on the consumer side — within the Internet marketplace.

Likewise, over the past 20–30 years, the Media industry has been one of the steadiest growth markets. Since 1960, there have been only three down years in ad spending in the United States, despite the occurrence of five recessions during that period. Ad spending has outpaced GDP growth by 3.1x over the last decade, a period during which economic growth itself has been fairly robust. Now, with the advent of the Internet, the Media industry has gained a new low-cost delivery and communications channel that may be the first truly global distribution platform the world has seen. From broadcast radio and television to cable and satellite television to print media, all sectors of the Media industry are enjoying increased revenue growth and expanded business opportunity with the advent of the Internet. Time Warner is positioned squarely at or near the top of several media segments — magazines, music, cable, and filmed entertainment — and is poised to ride the accelerating wave of growth washing through the Media industry.

By putting AOL's Internet presence together with Time Warner's media stature, we believe that not only will the two companies be able to share in the growth of their respective fields, but also, a combined AOL Time Warner would be able to generate its own tailwind of additional growth over the next five to ten years. In simple mathematical terms, combining AOL's 35%-40% EBITDA growth trajectory with Time Warner's 13%-14% EBITDA growth outlook yields a combined growth rate of something in the low-20% range, say 21%-plus annually in the next five years. From a top-down perspective, we believe that the combination of these two companies — their assets, opportunities, financial resources, and ability to jointly create new businesses — will easily be enough to lift the combined company's EBITDA growth rate to 25%-plus per year.

8. Where do $1 billion in first-year synergies come from?

In a merged company with more than $40 billion in combined projected 2001 revenue and $30 billion in combined expenses, finding 10% more EBITDA in the first year should not be overly challenging.

AOL and Time Warner management have openly stated that the combined company should be able to produce an incremental $1 billion in EBITDA in the first year of combination, when the final results are compared to pre-existing estimates for the two companies on their own. While we believe the company's target is attainable, there has been some investor pushback on the $1 billion figure, largely because, without obvious overlapping cost areas that might be slashed wholesale, an immediate categorization of the sources of the proposed synergy is not easily formed.

However, we believe investors ought to consider the following "back-of-the-envelope" estimates before ruling out the likelihood of a combined AOL Time Warner achieving the stated EBITDA goals:

- AOL and Time Warner generated roughly $6 billion in combined advertising revenue in 1999, and current estimates for both companies on a standalone basis would put that figure close to $9 billion in 2001, before any effect from the merger. A 5% increase in advertising revenue by dint of the merger and a program of concerted packaged advertising sales would yield $450 million in additional ad revenue in 2001. At a 65%-80% incremental margin on that ad revenue uplift, AOL Time Warner could capture an additional $300-$350 million in EBITDA as a combined company.
- Drawing upon industry statistics, we believe that Time Warner's magazine group spends somewhere between $420 million and $540 million on subscription marketing or customer acquisition each year, while AOL itself will spend roughly $1 billion on marketing in 2000. However, the merger should afford both AOL and the Time, Inc. publishing group attractive new marketing opportunities and efficiencies. We anticipate that Time, Inc. magazines will be marketed through the AOL service, a new potential source of readers for a business in an industry that has struggled with the declining effectiveness of traditional stamp-sheet, sweepstakes and direct mail techniques. Likewise, we expect that the AOL service and software will be distributed inside Time, Inc.'s magazines and books, on Warner music CDs, in the Warner Bros. stores, and throughout several other Time Warner distribution channels. Furthermore, AOL would have the opportunity to gain "free" advertising exposure in "remnant" space within Time Warner publications and on its television networks. A 10%-15% reduction in the combined marketing spending for the merged company would yield $140–$230 million in additional EBITDA.
- Time Warner's Digital Media division currently expects to lose $200–$250 million in EBITDA in 2000, in the process of building, operating and promoting its online properties. However, the pending merger with AOL would give Time Warner's online businesses a host of new distribution, infrastructure, and revenue production opportunities, in our view. Time Warner online brands, such as the CNN.com group of sites and the new Entertaindom domain, will be able to tap into not only the audience presence and positioning capabilities of the AOL service, but also those of Netscape, CompuServe, ICQ, MovieFone, and other AOL franchises. We believe Time Warner may be able to shave $100–

$125 million off of its online budget, and cut out a like amount of EBITDA losses, thanks to the infrastructure and distribution clout of AOL.

- Although it stands to be a far larger source of incremental cash flow in the longer term, we believe AOL Time Warner together will be able to accelerate the sale of broadband cable services in a way that will impact 2001 results, at least to an initial degree. For instance, if AOL could feed Time Warner an additional quarter million broadband Internet subscribers above current 2001 projections, the added $10 or so per subscriber per month in broadband Internet profit would amount to $30 million in additional EBITDA. Likewise, the bundling of Internet services with digital cable television services could lift Time Warner's cable take rates. On 13 million existing Time Warner cable subscribers, a 5% increase in premium service subscribership with just $5 per month in added per-sub cash flow would add up to $40 million in extra cash flow.

- While the long-term synergy impact of the proposed merger would likely center around revenue enhancements and new business opportunities, the companies should be able to find several near-term areas of very traditional merger-related cost savings. For instance, AOL and Time Warner might be able to combine many of the customer service functions that support AOL, the cable systems and magazine businesses. Likewise, content acquisition and royalty payments by AOL to Time Warner and other media companies can be recaptured or reduced by using the combined company's own content. We believe the data, telecom and technology purchasing of the two companies could be pooled and leveraged, affording some additional reductions in the cost profile. All told, these "classic" cost savings opportunities might amount to $100 million or more in a company with $30 billion in total expenses, in our opinion.

We believe the few synergies outlined above would total anywhere from $700-$875 million in additional EBITDA for the combined company, above and beyond current cash flow projections. Other EBITDA synergy areas, such as online music sales, in-house promotion of motion pictures, the leveraged launch of AOL TV, improved subscriber retention at AOL and at the magazine group, and shared billing and account management activities, are similarly ripe for the picking should AOL and Time Warner put their collective efforts behind ratcheting up revenue, profitability, and cash flow.

In the end, quantifying 2001 merger synergies on a line-by-line basis, before the merger is approved, from the distance of early 2000 is an uncertain endeavor. Generally speaking, we expect slightly less than half of the cash flow upside in 2001 to come from revenue enhancements, with slightly more originating from efficiencies and cost savings. An alternative way to think about the potential to unlock added cash flow is a top-down approach: If revenue grows 2% faster, and costs grow 2% more slowly as a function of the merger in 2001, the $700–$750 million top-line lift and $600 million expense impact will likely produce $1 billion in extra cash flow, in our view.

While the achievement of the targeted synergies would be an important indication of the pending merger's effectiveness and wisdom, we believe investors should avoid becoming overly preoccupied on the synergy line. We do not believe the realization of $1 billion in EBITDA uplift will be all that difficult to achieve, nor will it be as transparent and sourceable as even our back-of-the-envelope calculations above portray. Instead, we believe investors should focus on the product, cultural, and growth momentum of the new company. For even if the $1 billion synergies turn out to be as easily attained as we believe, it would ultimately be AOL Time Warner's longer-term growth, as well as its ability to sustain and expand its current businesses and margins, that will drive valuation and shareholder returns, in our view.

7. Why does AOL need to buy and own content?

We believe a tremendous and rising amount of value resides in ownership of world-class content, particularly in AOL's situation, given the company's presence at the center of the new media, commerce and communications channel that is the Internet.

AOL's motivations: defining how content will look and using content to capture more value.

We believe AOL's motivations to own content can be boiled down to two primary considerations: 1) AOL wants to be in the position to create and define what kind of content will be available to consumers in the future, particularly as the Internet becomes more familiar, faster, and increasingly ubiquitous; 2) AOL seeks to position itself to capture a larger share of the value that is being created as usage of the Internet increases.

As the nature of the Internet evolves to become more mainstream- and entertainment-oriented, entirely new forms of content are emerging. The networked experience of the Internet essentially demands that content become more interactive, and the underlying technical capabilities of the medium emphasize personalization in ways traditional media do not. While there is no shortage of content available on the Internet, the amount of truly interactive, personalized content out there is still a relatively small component of the overall Web. AOL and Time Warner have recognized, in our opinion, that neither company was perfectly positioned to develop the ideal set of content going forward. AOL is a master of interactivity, but lacks deep, proprietary content resources; Time Warner is long on content across many media categories, but Time Warner's Pathfinder and Full Service Network experiments revealed the company's shortcomings in interactivity and technology. We believe that a combined AOL Time Warner would have all the ingredients — people, content, technology, infrastructure, brands, audiences, distribution platforms, financial wherewithal — to produce new forms of content and new interactive services that can define and model what the future of media will look like.

Next, as AOL examines usage trends within its own service, it is clear that as users advance toward stronger technology, faster access speeds, and greater familiarity with the Internet, the percentage of their time spent consuming and interacting with content and online destinations is growing. As a result, the proportion of the value to be derived from users' time online is tilting ever-further toward those who own and control the content and destinations that the consumers are seeking out.

Build, "rent," or own?

Recognizing the growing value of content within the online environment, AOL has three strategic options to participate in that trend: 1) Build content of its own; 2) "rent" content from third parties; or 3) acquire content ownership outright. The first alternative would require AOL to make a fairly massive investment in the people and resources to create world-class content of its own. Even then, AOL's content would have to compete in the market against that of myriad more well-established content providers, battling all the while to build its own content brand and franchises.

The second alternative, that of "renting" content, is a less expensive option, but one that also has its risks. Indeed, the television networks are a good example of how the content rental model can be made to work. Specifically, we note that NBC does not own, and is not directly affiliated with, a major content production studio, yet NBC's large audience and programming prowess have enabled it to compete for licensed content in a successful and profitable way. We would argue that AOL has pursued a similar content licensing model historically: Companies like SportsLine, CBS News, *The New York Times*, and Oxygen Media have entered into large, multi-year content deals with AOL, publishing their content through the AOL service to AOL's vast membership base.

AOL has benefited from not owning and having to invest to produce the content it delivers; yet, the company has been able to derive value from putting that third-party content in front of its users. In fact, AOL has even been able to charge these content partners for the distribution of their content through AOL. However, in a world where the major media companies are getting more aggressive and skilled about bringing their brands and content to the Internet, and in an environment where even AOL does not really control the distribution platform of the Internet and consumers can circumvent AOL to get to the content they desire the most, it is questionable as to whether AOL will continue to be able to wield such great power over the content owners. The risk to AOL in the content rental model is the same risk that NBC faces in having to pay ever-escalating prices for its choicest content (think of the ever-escalating costs of "ER" and the NBA to NBC).

Ownership of content will lower risks and increase returns for AOL.

The third content option, acquiring content that AOL would then own and control, will turn out to be the most attractive model in the long term, in our opinion. In comparison to building its own content businesses and establishing new brands in the process, the combination of AOL with a large and well-established content powerhouse like Time Warner, in our view, promises a lower risk profile and higher returns. Not only would AOL be able to use Time Warner's content within the online realm, but also, Time Warner's franchises would be used to promote AOL. Meanwhile, Time Warner's content businesses (Filmed Entertainment and Music) themselves are already strongly cash generative, with an overall EBITDA margin of 12%. Furthermore, AOL would be able to jump-start its content efforts with the established brands and audiences that already reside in Time Warner.

In comparison to the content licensing model previously pursued by AOL, we believe that gaining control of these content assets and resources would allow AOL to capture more (read: all) of the additional value to be created from distributing Time Warner content over AOL and from using Time Warner's base to build new interactive content franchises. As an aside, we also note that each of Time Warner's content businesses has its own unique distribution network, and that the combined company will gain strategic advantage from being able to leverage any of its content across the widest array of distribution channels in the media business.

Of course, the downside of acquiring an existing content pool, such as that of Time Warner, is that AOL would take on the slower growth profile that still resides in Time Warner's traditional businesses. However, we believe that given the opportunity to capture more value in the online world by focusing more heavily on content, and faced with the content alternatives outlined above, AOL has selected the path that will yield the greatest long-term strategic value and financial reward.

6. Was it Time Warner's cable systems, AOL's broadband conundrum, or AOL's high stock price that really drove the deal?

It was none of the above.

In our view, each of the above-mentioned motivations played some role in the AOL Time Warner merger, but none of them was the primary reason or justification. As detailed throughout this report, we believe that the proposed merger is much more about content and the changing face of opportunity in the media and Internet worlds, rather than about a single distribution technology, a perceived strategic impasse on broadband, or a lofty share price at AOL.

Cable: Appealing "side dish" to TWX.

To be sure, we believe Time Warner's cable television footprint holds exceptional strategic value for AOL at present. By joining up with the second-largest cable system in the United States, AOL would have access to that system as an incubating laboratory for new services such as AOL TV and AOL Plus, the company's broadband service. AOL would be able to design, experiment with, and develop these and other cable-delivered services "in its own backyard." Potentially sticky technological issues and intense financial negotiations that would be required to perfect and deploy AOL's new cable services should be obviated by putting AOL and Time Warner on the same side of the table. However, as we see it, Time Warner's cable television plant was really just an attractive "side dish" that made Time Warner more attractive to AOL than any one of several other content-strong potential partners.

5. What is likely to happen on the AT&T front?

New alliances between AOL Time Warner and AT&T are highly likely, in our view.

Strategic triangulation adds flexibility and opens possibilities.

The three companies, AOL, Time Warner, and AT&T, have already spent the better part of the past year circling around each other in ever closer orbits. Now, with AOL and Time Warner aiming to combine as a single entity, we believe that the logjams between the companies will be broken by simplified strategic interests and improved negotiating flexibility, at AOL Time Warner in particular. The upshot is that many of the strategic moves that AOL, Time Warner and AT&T investors have long awaited are now increasingly likely, in our view, offering potentially good news in both directions.

In retrospect, it is somewhat hard to imagine how these three companies, with so many overlapping interests and tangentially connected businesses, have managed to get along for so long without closer strategic alliances between them. Looking ahead, however, we believe that with the prospect of AOL and Time Warner now approaching AT&T from the same side of the table and with a long list of strategic priorities and desires on all sides, material new agreements will be hammered out.

From AOL Time Warner's perspective, the priorities would likely be gaining access for AOL to the AT&T cable and wireless systems and their customers, and resolving the ownership and future of RoadRunner. From AT&T's perspective, the top priority would likely be access to Time Warner's cable systems for AT&T telephony service, followed by gaining a share of AOL's data traffic (through narrowband, broadband, wireless devices, etc.) and potentially cleaning up the ownership structure of the Time Warner Entertainment (TWE) partnership. AT&T could also be interested in advertising across the AOL properties. From an AOL Time Warner investment perspective, the opening up of AT&T's cable and wireless plants to a partnership with AOL would be likely to have the greatest value and near-term reward, in our opinion.

AOL and Time Warner have both been in discussions with AT&T about these matters since well before the merger was announced; however, we believe that these discussions may now become more fruitful in the wake of the merger announcement. AOL and Time Warner should have more flexibility and more numerous negotiating alternatives in combination than they did individually. Furthermore, from AT&T's perspective, with its MediaOne purchase moving closer to completion, the time to enter new alliances or modify existing ones, with either AOL or Time Warner, is right.

Handicapping alliances, strategic partnerships, and corporate negotiations as complicated as these might be is always a challenge; guessing at the outcomes is more difficult. However, we are confident that AOL Time Warner and AT&T should have enough common ground, mutually beneficial potential, and strategic flexibility to make something work between the two companies.

4. Who will run the combined company?

The senior management structure of a merged AOL Time Warner is one of the most carefully considered elements of the transaction, to our knowledge.

The uppermost ranks are an Internet and Media all-star team.

Upon consummation of the merger, AOL Chairman and CEO Steve Case would become the chairman of AOL Time Warner; Time Warner Chairman and CEO Gerald Levin would be the CEO of the new company; AOL President Bob Pittman and Time Warner President Dick Parsons would be co-chief operating officers of AOL Time Warner, and AOL CFO Mike Kelly would remain as the new company's financial chief. Ted Turner, Time Warner's vice chairman, would become vice chairman of AOL Time Warner. The board of directors would be made up of 16 people, drawn equally from the boards of AOL and Time Warner. Beyond these appointments, the rest of the organizational structure and management team of AOL Time Warner should be formalized over time as the business opportunities are better defined and understood.

Although the full details of AOL Time Warner's management structure will be developed later, the responsibilities of the senior-most management team already have been articulated clearly. Upon consummation of the merger, Mr. Case would focus primarily on broad strategy for AOL Time Warner, technological developments, and policy issues. Jerry Levin would define the company's strategy and oversee the management of AOL Time Warner. We note that Jerry Levin's management contract extends for roughly another four years, and we expect that throughout that time Mr. Levin will hold the CEO office. Furthermore, Bob Pittman's experience in both the Media and Internet businesses — he was one of the founders of MTV and spent more years at Time Warner than he has at AOL — establishes him as one of the most well-versed, experienced and important executives in the new company. We believe Mr. Pittman would be the executive most likely to see his responsibilities increase over the intermediate term.

Divisional decisions and structure will be allowed to gel in time.

During the integration period, AOL Time Warner would establish a four-person integration committee composed of Bob Pittman, Richard Parsons, Kenneth Novack (AOL's vice chairman) and Richard Bressler (Time Warner's chairman and CEO of Digital Media). Based on discussions with management, we believe the integration committee will first make a broad assessment of each business and the opportunities ahead before developing any final management structures. In our opinion, this approach is correct given the unique nature of this combination. By first identifying opportunities before setting operating guidelines, we believe AOL Time Warner would be able to more effectively capitalize on cross-divisional opportunities.

At the end of the day, we believe a combined AOL Time Warner would be able to draw on one of the deepest and most experienced management pools in any company within the broad Internet and Media sectors. Ultimately, AOL Time Warner could be managed in a decentralized fashion, similar to Time Warner's historical operating structure. In the early days of the Time, Inc./Warner Communications merger, this strategy resulted in unhealthy corporate infighting; however, the recent operational success of Time Warner suggests that its management style could breed both strong internal growth as well as inter-divisional synergies.

While mega-mergers are notoriously challenging from an execution standpoint, we believe the acquisition track records of both AOL and Time Warner provide encouragement. AOL has been successful in integrating several recent acquisitions such as Netscape and MovieFone, while Time Warner's purchase of Turner Broadcasting has been a home run. Although the merits of the Time and Warner merger took a long time to materialize, we view that transaction as ultimately successful, as well. The integration challenges are daunting, but surmountable for a combined AOL Time Warner, in our view.

3. What's the process and timing to close the deal?

The merger was announced on January 10, 2000, and we expect the transaction to close during the fourth quarter of 2000.

AOL and Time Warner filed their merger with the SEC in February 2000, and should receive comments back from the SEC within the next several weeks. We anticipate that approval from the SEC could come by May or June 2000. Simultaneously, AOL and Time Warner are seeking antitrust and fair trade approval.

The companies must get federal antitrust approval in the United States and merger approval in the European Community. These proceedings are likely to take six to nine months in the United States, a little less time in Europe. Additionally, the Federal Communications Commission (FCC) must approve the transfer of Time Warner's broadcasting, cable system, and cable network licenses to the new company. Further, many state and municipal cable franchise authorities will have to approve the transfer of Time Warner's cable franchises, a process that could also take six to nine months, including a period of public comment. However, the closure of the deal is not contingent on receiving approval from every municipal authority.

The Federal Trade Commission (FTC) is also reviewing the merger, and both Time Warner and AOL have appeared before Congress to discuss the merger. In the end, we expect the companies to gain approval for the transaction pretty much as proposed, although the government does have an ability (not likely to be used here, in our opinion) to condition the merger on divestitures, operating restrictions, and other agreements. In our view, however, it is highly unlikely that the government will condition the merger, given the lack of overlapping businesses and the lack of aggregation of market share in one single industry. Instead, we believe that Time Warner's proposed merger with EMI will receive the most scrutiny, although we note that the AOL/Time Warner deal is not contingent on this approval.

Beyond the nine-month regulatory process, AOL and Time Warner also need shareholder approval for the merger to go through. Once AOL Time Warner receives SEC clearance, AOL and Time Warner will be able to put the proposed merger to a shareholder vote, which should take place in June 2000 and can occur prior to antitrust approval. According to our analysis, the swing factor in approving the merger is likely to be AOL's individual shareholder base, which controls about one-half of AOL's shares. If we assume that at least three-quarters of the institutional investors will vote in favor of the merger, then AOL would need only one-sixth of its individual investors to back the merger in order to win approval. In reality. we believe the merger is likely to be approved by a wider margin. We note that all 130 million Time Warner management options have already vested (excluding those granted this year) at the time the merger was announced. As of year-end 1999, another 315 million AOL management options will vest one year after the closing (or, with dilution, 200 million).

The mistakes of Time and Warner must be avoided.

The management risk lies in getting both the Time Warner and primary pre-merger AOL teams to weave their businesses together in a cooperative fashion. While the right incentives will be put in place, Time Warner has a history of fiefdoms that occasionally have had difficulty working together. For instance, Time Warner's ongoing frustrations in its interactive and online endeavors might fairly be chalked up to an inability to get diverse business units to work together. On the other hand, the rash of joint announcements between AOL and Time Warner that has taken place since the merger was announced suggests that the teams already have established at least one mission—driving interactivity into all aspects of entertainment.

While the usual regulatory and shareholder voting processes are taking place, AOL and Time Warner are not losing any time in starting to work together more closely, in our view. Co-marketing agreements, cooperative product development efforts, and important public and operating policy understandings are already being released. In many ways, we believe AOL and Time Warner are already "virtually merged," with management teams and operating groups meeting with each other frequently and getting started on the hard integration work ahead. Also, due to the lack of overlapping businesses, we believe that employee attrition should be minimal. In fact, management has expressly stated that they want to try and retain the highly experienced employees of both companies who collectively embody a vast amount of knowledge of the separate businesses of AOL and Time Warner.

2. What are the catalysts that could propel the stock?

Partnerships, products and portfolio positioning.

Strategic agreements with AT&T, carriage of AOL service across Time Warner's cable systems, new wireless alliances, the introduction of AOL TV and AOL Plus, a restructuring of AOL Europe, solid quarterly financial results, and the possible strategic partnership or acquisition could each provide a catalyst for the shares of AOL and Time Warner, even before the merger is closed, in our view.

Beyond the merger's close, we believe strong financial performance, headway on the broadband front, and the creation of new products, services and businesses from the combined assets of both companies are the most likely long-term energizers for the share price. From a market structure standpoint, AOL Time Warner combined would represent approximately 2.8% of the S&P 500 Index, and portfolio rebalancing around the time of the merger could lead to a short period of heavier buying in the name.

1. How the heck do we value it? And, what's it worth?

Free cash flow growth points to a $115 per share value.

Although the initial inclination in valuing AOL Time Warner is to steer toward the Enterprise Value-to-EBITDA multiple method that is the mainstay of the media industry, we believe AOL Time Warner's free cash flow provides a stronger valuation benchmark. We believe AOL Time Warner should trade at a free cash flow multiple two times its free cash flow growth rate of 50% per year, and arrive at a $115 per share price target for the combined company.

Traditional EBITDA models oversimplify.

The traditional Enterprise Value-to-EBITDA valuation approach has two limitations in its application to AOL Time Warner, in our view. First, truly comparable peers are difficult to identify, as no other company or group of companies possesses the same mix of world-class media assets and Internet leadership that AOL Time Warner could soon claim. Without directly comparable peers, the determination of an appropriate EBITDA multiple for AOL Time Warner becomes somewhat of a "pot luck" exercise, tossing together multiples, growth rates, and multiples of growth rates from other media, technology and communications companies to come up with a valuation target. Unfortunately, in a market where Yahoo! trades at 305x EBITDA and roughly 2x EBITDA growth and Fox Entertainment Group (FOX) trades at 14x EBITDA, 1x EBITDA growth, the comparables are almost too widely scattered to be useful.

Second, we believe that the traditional Enterprise Value to EBITDA valuation shorthand fails to recognize several important and differentiating financial attributes that should characterize a combined AOL Time Warner. Compared to most media or communications companies, AOL's business is less capital intensive, with capital expenditures running only 5%-7% of sales in each of the last three years at AOL versus a range closer to 8%-10% for most of the major media and communications companies. Likewise, on Time Warner's side, the company is just now coming off of a cycle of significant and necessary capital expenditures in its cable systems, and the company is shifting to a mode of sharply reduced and highly discretionary capital investment in this area. Time Warner's cable system spending is transitioning to a variable model, where set top box and subscriber system investments promise immediate revenue increments and a 30% after tax rate of return. Furthermore, both AOL and Time Warner's magazine publishing operations tend to spin off prepaid cash amounts that lead to negative working capital requirements as subscriptions are paid in advance. Finally, AOL's advertising and e-commerce business model, which currently holds a deferred revenue balance of over $2.4 billion, and Time Warner's entertainment and television syndication business, with a contracted revenue backlog of $3.6 billion, will be added sources of material upfront liquidity and unique cash flow predictability for the combined company. Of course, Time Warner's entertainment businesses, such as motion pictures, television production and music, will still require normal levels of ongoing capital expenditure and working capital investment, yet the overall free cash flow production at a combined AOL Time Warner promises to be impressive.

Given the foregoing observations, we believe that AOL Time Warner is best valued on the basis of its free cash flow. By grounding the valuation in free cash flow, we strive to closely reflect AOL Time Warner's ability to generate cash returns for shareholders, which at the end of the day are the one true source of equity value, in our opinion. Furthermore, given that AOL Time Warner will sit at the confluence of the media, Internet and communications industries, we believe that the company will not only have the ability to consistently generate and rapidly grow its free cash flow, but will also have ample attractive free cash reinvestment opportunities. AOL Time Warner's free cash flow will be deployed to develop and launch many new products and services over the next three to five years, any of which may reshape the nature of the industries in which the company is engaged.

AOL Time Warner will trade among giants

Choosing free cash flow as our valuation yardstick, we will look to the ranks of other large scale, market leading companies for guidance on the appropriate multiples and our ultimate valuation objective. Specifically, we believe AOL Time Warner should be evaluated on free cash flow terms within the context of other market capitalization giants, such as Microsoft, Cisco Systems, General Electric, Intel, Exxon-Mobil, Wal-Mart, Oracle, Lucent and IBM. That group, with AOL Time Warner included after the merger, is likely to represent the ten largest, most liquid, most widely held companies in the U.S. market.

Figure 2. Free Cash Flow Valuation Among Market Capitalization Leaders

Company	Ticker	Stock Price	Shares Outst.	Market Cap.	Free Cash Flow Per Share 1998	1999	2000E	2001E	Annual FCF Growth Rates 98-01E	99-01E	00-01E	Price to FCF Ratio 1999	2000E	2001E	FCF Multiple / Growth Rate 00/3 Yr	00/2 Yr	2001E
Microsoft	MSFT	$97	5,514	$536,926	$1.26	$1.83	$2.11	$2.50	26%	17%	18%	53.4	46.0	38.9	1.80	2.69	2.12
Cisco	CSCO	134	3,669	492,071	0.78	1.15	0.53	1.27	18%	5%	140%	116.4	254.4	105.9	14.53	52.47	0.75
General Electric	GE	141	3,335	470,027	8.31	6.09	7.76	8.85	2%	21%	14%	23.2	18.2	15.9	8.56	0.88	1.13
Intel	INTC	135	3,500	472,500	1.60	2.60	3.00	3.48	30%	16%	16%	52.0	45.1	38.8	1.53	2.85	2.38
AOL - Time Warner	**AOL**	**67**	**4,786**	**320,055**	**NM**	**NM**	**0.78**	**1.15**	**NM**	**NM**	**50%**	**NM**	**85.3**	**58.2**	**NM**	**NM**	**1.16**
Exxon-Mobil	XON	75	3,533	264,533	0.66	1.51	1.94	1.69	37%	6%	(13%)	49.6	38.5	44.2	1.04	6.53	(3.44)
WalMart	WMT	55	4,479	246,905	0.82	0.78	1.26	1.43	20%	36%	14%	71.0	43.8	38.6	2.16	1.23	2.84
Oracle	ORCL	78	3,003	234,627	0.39	0.47	0.68	0.89	32%	37%	30%	165.1	114.3	87.7	3.63	3.07	2.89
Lucent	LU	67	3,293	220,631	(0.34)	(0.28)	2.30	(0.42)	7%	22%	(118%)	(236.3)	29.1	(159.7)	4.00	1.34	1.35
IBM	IBM	113	1,808	203,829	0.67	4.93	2.21	3.40	72%	(17%)	54%	22.9	51.1	33.1	0.71	(3.02)	0.61
Average									27%	16%	21%	35.2	72.6	30.2	4.22	7.56	1.18
Average, Excl-Outliers (ie- Growth Rates >100% and <10%)									33%	22%	27%	75.7	50.5	42.9	3.63	2.17	1.83
Average, Top 4 + Oracle									21%	19%	44%	82.0	95.6	57.4	6.01	12.39	1.85
Average of MSFT, CSCO, INTC, ORCL									26%	19%	51%	96.7	115.0	67.8	5.37	15.27	2.04
Average of MSFT, ORCL									29%	27%	24%	109.2	80.2	63.3	2.71	2.88	2.50

Note: Free Cash Flow = Net Income plus Depr. & Amort., less Capital Expenditures and Change in Non-Cash Working Capital
Numbers not adjusted for fiscal years. Microsoft Fiscal Year-End is June 30. Cisco Fiscal Year-End is the last week of July. General Electric Fiscal Year-End is December 31. Intel Fiscal Year-End is December 25/26. Exxon-Mobile Fiscal Year-End is December. Wal Mart Fiscal Year-End is January 31 of the following year. Oracle Fiscal Year-End is May 31. Lucent Fiscal Year-End is September 30. IBM Fiscal Year-End is December 31.

Source: Company reports and Salomon Smith Barney

Inexpensive on free cash flow and a cheap place to buy FCF growth.

Our free cash flow analysis and valuation conclusions are discussed in greater depth below, and we note that the ten largest companies in the market are currently valued at an average of about 30 times estimated 2001 free cash flow. However, we believe that free cash flow growth, in addition to absolute free cash flow levels, is an important determinant of these companies' comparative free cash flow valuations. With a couple exceptions, the ten largest companies in the United States trade at free cash flow multiples equal to 1x–3x their projected free cash flow growth rates. At a 2001 free cash flow multiple of just over 1x expected free cash flow growth, AOL Time Warner is currently the third least expensive company in this mega-capitalization peer group.

Healthy free cash flow dynamics.

We believe that a combined AOL Time Warner would offer some of the most predictable and rapid growth in free cash flow among these top quality, large capitalization peers. The underlying growth in AOL Time Warner's EBITDA and net income should be comfortably above 20% per year for the next five years, with a 30% EBITDA gain expected in 2001. Furthermore, AOL Time Warner's anticipated growth can be achieved with only minimal capital expenditure given the nature of the company's businesses and it recent infrastructure investment accomplishments. Meanwhile, working capital should require little additional investment throughout this period at the least, and in a best case scenario, working capital is more likely to be a source of additional free cash flow assuming the subscriber growth, television syndication and advertising/e-commerce engines continue to fire as they recently have done.

MSFT, CSCO, INTC, ORCL, and perhaps GE are the best comparables.

Looking through the financials of the other leading capitalization companies available to investors, we believe that the merged AOL Time Warner's free cash flow profile is most closely mirrored by those companies with steady and strong underlying net income growth, limited capital expenditures and a favorable working capital dynamic. Specifically, we believe Microsoft, Cisco, Intel, and Oracle have the most directly similar free cash flow characteristics. Although General Electric is more capital intensive than these, its steady income growth and consistent working capital cash production might argue for that company's inclusion as well. On average, the Microsoft, Cisco, General Electric, Intel, and Oracle peer group are trading at free cash flow multiples of 1.8x their free cash flow growth rates on 2001 estimates. Excluding General Electric, the average is 2x free cash flow growth. Focusing on Microsoft and Oracle alone, the least capital intensive of the peer group, the average multiple-to-growth rate ratio is 2.5x 2001 estimates.

Given our analysis, we believe that the stock of a merged AOL Time Warner should trade at a free cash flow multiple equal to two times its free cash flow growth. With a free cash flow growth rate that we believe will be 50% per year for several years beyond the merger, we target a free cash flow multiple of 100 for AOL Time Warner. At that level, AOL Time Warner would be the fifth most highly valued company in our peer group on this measure, and roughly in-line with the multiple accorded to Cisco. At 100 times estimated free cash flow of $1.15 per share in 2001, our 12- to 18-month price target for a combined AOL Time Warner is $115 per share.

Execution is a risk not easily captured in a simple multiple.

Since AOL Time Warner is a yet-to-be merged entity, whereas Microsoft, Cisco, General Electric, Intel, and Oracle are well-established operating companies with existing track records, a case could be made for the application of an integration risk or uncertainty discount to AOL Time Warner's free cash flow multiple. However, we believe that the demonstrated commitment of AOL and Time Warner to begin working together and joining forces, both tactically and strategically, well before the closing of the merger mitigates a portion of the normal merger-related valuation risk. Furthermore, we believe that in building a valuation case for a merger that could create as many advantages and opportunities as we believe the AOL Time Warner transaction does, investors who have reached the conclusion, as we have, that the new company will represent an attractive and unique investment vehicle should approach the valuation process with conviction, rather than timidity. Thus, instead of haircutting our valuation target to fold in a margin of safety or to discount integration risk, we prefer to set our price target using the most appropriate financial yardstick at a fair level relative to what we believe are the correct comparables and leave it at that.